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
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APRIL 1996

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LEGISLATOR PER DIEM PAYMENTS -- TAX CONSIDERATIONS

This information is intended to assist legislators and their tax preparers in handling legislative per diem payments. Legislators should consult with their income tax preparers for specific requirements relating to individual circumstances.

General Rules

All legislator per diem payments made to legislators living more than 50 miles from the Capitol building are reimbursements made under an accountable plan, are not taxable income of the legislator, and are not subject to withholding or reporting. The difference between the per diem paid and the amount allowed by federal law for reimbursement is treated as unreimbursed expenses and, subject to certain limitations, is allowed as a miscellaneous items deduction by the legislator.

Legislator per diem payments made to legislators who do not live in Helena but who live within 50 miles of the Capitol building are not substantiated reimbursements and are thus reported as income. Withholding is made against these payments. All legislative lodging and meal expenses actually incurred by the legislator are unreimbursed expenses and, subject to certain limitations, may be a miscellaneous items deduction by the legislator.

PLEASE RETURN

Legislator per diem payments made to legislators who reside in Helena are reported as income and are subject to withholding. The legislator may not claim meal and lodging expenses incurred in Helena.

Accountable Plan

All legislator per diem payments made to a legislator whose home is more than 50 miles from the Capitol building are employee reimbursements under an accountable plan for the following reasons:

- (1) IRC section 162(h) eliminates requirements for a legislator to substantiate an overnight stay.
- (2) The per diem payment to legislators is \$50 per legislative day. (5-2-301(3), MCA) Federal law provides one type of accountable plan for when the employee's "lodging plus meals and incidental expenses" per diem reimbursement is less than the amount computed for the federal per diem rate. (IRC section 62(a)(1)(A), 26 CFR 1.62-2) For Montana, the applicable reimbursement rate, set forth in 41 CFR Ch. 301 App. A, is \$70--\$44 for lodging and \$26 for meals and incidental expenses.

Reimbursements paid "under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA)...". (26 CFR 1.62-2(c)(4)) Therefore, all legislators living more than 50 miles from the Capitol building do not have their per diem payments reported on their W-2 Form.

Under 26 USC 162(h)(4), the special provisions allowing use of the federal per diem rate do not apply to legislators living within 50 miles of the Capitol building. Therefore, those legislators must follow the provisions of 26 USC 274(d); must specifically substantiate all lodging and meal expenses; and cannot take advantage of unreimbursed expenses set forth below. Because 26 USC 274(d) requires out-of-town travel before a person can claim lodging and meal expenses, a legislator who lives in Helena cannot claim any meal or travel expenses for session activities occurring within Helena.

Unreimbursed Expenses

All legislators who live more than 50 miles from the Capitol building are considered to have substantiated expenses equal to \$70 a day, but they receive only \$50 in per diem payments. Under 26 CFR 1.62-1T(e)(4), the legislator is allowed as a deduction a portion of this unreimbursed expense. The amount of the deduction is determined as follows:

- (1) The \$20 difference must be allocated between lodging and meals in the same ratio as is set forth in the schedule in 41 CFR Ch. 301 App. A, after subtracting \$2 (the amount allocated to incidental expenses) from the meals and incidental expenses amount. The ratio of \$44/\$24 is 65%/35%. Thus, of the \$20, \$13 is allocated to unreimbursed lodging expenses and \$7 to unreimbursed meal expenses.
- (2) All of the \$13 lodging expense and 50% of the \$7 meal expense (see 26 USC 274(n)) are deductible, subject to the 2% floor on miscellaneous itemized deductions of 26 USC 67.

A qualifying legislator may receive per diem allowable travel reimbursement for each legislative day, as defined in 26 USC 167(h)(2). A legislative day is each day that the legislature was in session, including any day on which the legislature was not in session for a period of 4 consecutive days or less or any day when it was not in session but the physical presence of the legislator was formally recorded at a meeting of a committee of the legislature. During 1995, the Legislature was in session for 102 days that met the federal definition of a "legislative day". Per diem is paid for committee members' attendance at committee meetings held during the interim. Days in Helena on legislative business for which no per diem was paid are totally unreimbursed travel expense days and may be deducted as provided above, except that the base amounts are the daily allowable total of \$44 for lodging and \$26 for meals and incidental expenses.

JUVENILE JUSTICE AND MENTAL HEALTH STUDY COMMISSION

Commission to Meet in Great Falls...The Juvenile Justice and Mental Health Study Commission will hold its fifth meeting of the interim on April 15 and 16 in Great Falls at the MSU College of Technology. The

meeting will begin at 9 a.m. on April 15 and at 8 a.m. on April 16. The meeting will include a Commission work session on Monday at which the three subcommittees will present their preliminary findings and recommendations to the whole Commission.

A public hearing on juvenile issues will be held Monday night at 7 p.m. at the Providence Forum, McLaughlin Center, University of Great Falls.

Two More Meetings Scheduled...The Commission will hold two more meetings this interim. The Commission will meet in Missoula in July and in Helena in September.

For more information contact Susan Fox, Legislative Services Division, (406)444-3064.

CONSTRUCTION CONTRACTOR REGISTRATION

Construction Contractor Registration Moves Forward...Construction contractor registration, the new program created by Senate Bill No. 354, is moving towards implementation. Despite the confusion and controversy created by the new act, over 3000 construction contractors have already registered, and many more will be registering as the July 1 registration deadline approaches.

The Department of Labor and Industry is responsible for the implementation of the bill and has been working hard to spread the word about the new requirements and to educate both the construction industry and those who hire contractors about the new law.

Department to Hold Informational Workshops...As part of its education efforts, the Department is hosting workshops throughout the state for contractors and others interested in the program. In March, the Department conducted workshops in Malta, Glasgow, Scobey, Wolf Point, Roundup, Red Lodge, Columbus, Billings, and Hardin. The following workshops are scheduled in April:

4/12	3 to 5 pm	Sidney Elks Club 123 3rd Street SW
4/23	7 to 9 pm	Livingston Community Room City/County Complex 414 East Callender

4/24

7 to 9 pm

Bozeman Holiday Inn
City Center
507 W. Main

The Department will also host workshops in April, May, and June in and around Butte, Helena, Missoula, Kalispell, and Great Falls. For more information on the workshops or on the contractor registration program, call the Department's toll free number, 1-800-556-6694.

LEGISLATIVE SERVICES DIVISION

LEGAL SERVICES OFFICE

Ballot measures received:

- Constitutional term limits (Montanans for Term Limitation)
- Statutory term limits (Montanans for Term Limitation)
- Anti-intimidation law (Montana Anti-Extremist Coalition)
- Parking near crosswalk (Birkholz)
- Disclosure of governmental authority (Birkholz)
- Vehicle record disclosure (Birkholz)
- Fish and game law enforcement (Birkholz)
- Fishing by setline (Birkholz)
- Study by initiative (Birkholz)
- Insurance study (Birkholz)
- Court auditor (Birkholz)
- Revise campaign finance (Motl)

Note: pursuant to 13-27-202(2), MCA, copies of correspondence regarding the proposed ballot measures are available through the Secretary of State, (406)444-2034.

LIBRARY

Senate Natural Resources Minutes Now Available...Copies of the minutes for the 1995 Senate Natural Resources Committee are now available in the Legislative Library. Copies are currently being converted to microfiche and will be sent to those who ordered sets of microfiche minutes. Original minutes and tapes are available for review at the Historical Society Archives (225 N. Roberts, Helena, MT 59620-1201, (406)444-4775) and copies of the minutes are available at the State Law Library (215 N. Sanders, Helena, MT 59620-3004).

If you have questions, please call the Legislative Library at (406)444-3064.

SUBCOMMITTEE ON STATE MANAGEMENT SYSTEMS

Subcommittee to Meet in April...The SJR 23 Subcommittee on State Management Systems is scheduled to meet on Thursday and Friday, April 18 and 19. Anticipated agenda items include:

- a presentation by Department of Administration staff on the Department's vision for management information systems in the 21st century;
- separate reports from the Accounting Task Force, Budgeting Task Force (including updates on new developments with the executive budget system and legislative budget system and on potential statutory revision), and Data Management Task Force; and
- Subcommittee discussion on additional work for the remainder of the interim.

For further information, contact Dave Bohyer, Legislative Services Division, (406)444-3064 or Senator Mack Cole, (406)342-5384.

MONTANA TAX POLICY TASK FORCE

Montana Tax Policy Task Force to Hold Public Hearing...Montana taxpayers will have an opportunity to express their opinions regarding state taxation at the next meeting of the Montana Tax Policy Tax Force. The meeting will be held in Helena, April 12 and 13, in Room 415 of the State Capitol. The Friday meeting will begin at 9:00 a.m. and the Saturday meeting will begin at 8:00 a.m. Public comment may also be given Friday evening (April 12) from 7:00 p.m. to 9:00 p.m.

Interim Report Released...One focal point for public comment at the meeting will be the recommendations presented in the recently released "Interim Report of the Montana Tax Policy Task Force". The report provides recommendations for a two-year tax policy strategy--longer term strategies are still being discussed. The two-year policy recommendations address three areas of concern: property taxes, local government finance, and principles of taxation. The report may be obtained from the Montana Department of Revenue by calling (406) 444-2460, or it may be obtained through your local public library. The interim report is also available from the Department of Revenue on the state bulletin board (in Helena 444-5648 or 1-800-962-1729 toll free in Montana).

Task Force Recommends Property Tax Freeze...In the area of property taxes, the Task Force has recommended that the Montana Legislature consider passing legislation that would freeze property taxes for all governmental taxing units. The legislation, similar to SB 421 presented during the 1995 legislative session, would provide that taxing jurisdictions, including the state, could levy no more property tax than the amount levied in 1996. Taxing jurisdictions that experience a large increase in taxable value because of the reappraisal of residential and commercial property would be required to reduce their mill levies to ensure that no additional taxes are levied above the 1996 amount. The Department of Revenue would be required to reduce the 101 mills levied statewide for education for any increases in taxable value because of reappraisal. Reappraisal of all residential and commercial property is scheduled for the 1997 tax year.

Total property taxes could be increased above the 1996 level only for new growth and development, reductions in certain natural resource revenues, or for a school district whose budget is below the base budget required to meet the constitutional mandate of equal educational opportunity. Property taxes could also be increased with the approval of the voters in a district.

Task Force Makes Recommendations for Local Option Taxes...The Task Force has also proposed four recommendations in the area of local option taxes. The first recommendation would allow unincorporated areas currently

levying a resort tax to issue bonds backed by the anticipated resort tax revenue. Currently, only incorporated areas levying the resort tax are allowed to issue bonds. The second recommendation would provide for "transportation districts" that could levy up to \$0.02 per gallon on motor fuel for the construction, maintenance, or repair of public streets and roads. The district could be comprised of a county, a municipality, or a combination of both, with the levy allowed only through the approval of the voters in the district.

The third recommendation would provide greater flexibility to local governments in the use of the resort tax by allowing a resort tax area to include a combination of incorporated and unincorporated areas. The fourth recommendation would allow all Montana municipalities, upon approval of the electorate, the option of levying a "resort type" sales tax. Currently, only relatively small communities that derive the major portion of their economic well being from providing recreational services to transient taxpayers are permitted to adopt a resort tax. The resort tax is limited to the purchase of specific goods and services including accommodations, restaurants, taverns, and "luxury" items.

Task Force Recommends Adoption of Tax Policy Principles...Finally, the Task Force has recommended that the Legislature adopt principles by which tax policy and tax reform proposals should be gauged. Specifically, good tax policy should provide for stability and adequacy of revenue, provide for equity in taxation, be economically neutral and efficient, and be as simple to understand and administer as possible.

Public May Comment Via METNET...The public is invited to provide comments on these and other issues at the Friday or Saturday meetings. The public may also provide comments Friday evening, April 12, from 7:00 to 9:00 p.m., either at the meeting or via the Montana Educational Telecommunications Network (METNET). METNET is a communications system for providing two-way, interactive video between several different sites located throughout the state. The evening of April 12 participation in the tax policy deliberations will be available at the following METNET sites:

BILLINGS

MSU-Billings

Special Education Building, Room 162

1500 N. 30th Street

BOZEMAN

MSU-Bozeman

McCall Hall Studio

Corner of 11th and Grant

BUTTE

Montana Power Company/ENTECH
Hennessy Building, 2nd Floor Auditorium
130 N. Main

DILLON

Western Montana College
Lucy Carson Library
2nd Floor Emerick Room
710 S. Atlantic

GREAT FALLS

MSU College of Technology, Room 147
2100 16th Avenue South

HAVRE

MSU-Northern
Hagener Science Center, Room 202
300 11th Street West

HELENA

UM College of Technology, Room 211
1115. N. Roberts

KALISPELL

Flathead Valley Community College
Learning Resource Center, Room 120
777 Grandview Drive

MILES CITY

Miles Community College, Room 106
1715 Dickinson

MISSOULA

UM Field House, Room 161
South 6th Ave. East and
Van Buren Street

NATIONAL CONFERENCE OF STATE LEGISLATURES

Annual Meeting Scheduled for July...The National Conference of State Legislatures will hold its annual meeting on July 27-31 in St. Louis. Legislators wishing to attend may request the meeting brochure and registration materials by contacting the Legislative Services Division at (406)444-3064. Legislators who attend the NCSL Annual Meeting do so at their own expense.

GAMING ADVISORY COUNCIL

Council to Discuss Legislative Proposals...The Gaming Advisory Council will hold its next meeting on June 20 and 21 in Room 325 of the State Capitol. The meeting will begin at 9 a.m. on both days. The Council will discuss proposals to the 1997 Legislature, including electronic monitoring and reporting of video gambling machines.

For further information about the meeting, contact Wilbur W. Rehman, Gambling Control Division, (406)444-1971.

ENVIRONMENTAL QUALITY COUNCIL

Subcommittee Meets in March...The EQC Compliance and Enforcement Subcommittee met on March 20 and 21. At that time, the Subcommittee heard presentations on the status of compliance and enforcement programs within the Department of Environmental Quality. Those programs included the following:

- Motor Vehicle Recycling Program
- Solid Waste Program
- Hazardous Waste Program
- Underground Storage Tank (Release Prevention) Program
- Underground Storage Tank (Remediation) Program
- State Superfund Program
- Major Facility Siting Program
- Groundwater Program

- Storm Water Program
- Water Quality Program
- Enforcement Program

The Subcommittee has concluded its program review portion of the study. The Subcommittee, at its next meeting on April 25, will begin to select those issues that it has identified as needing further analysis. The Subcommittee is also considering asking the Environmental Protection Agency to attend the April meeting to respond to a number of issues that have been raised during the program review process.

For more information on these issues, please contact the EQC staff at (406)444-3742.

CAPITOL RESTORATION PROJECT

CAG Reviews Proposals for Capitol Exterior...Lois Menzies, Director of the Department of Administration, convened a meeting of the Capitol Advisory Group (CAG) on Tuesday, March 4 to review solutions for the repair of the exterior of the Capitol. Dennis Deppmeier, Project Architect, led the design team of Jim McDonald, Historic Architect, and Fran Gale, Stone Preservationist, in presenting options for the exterior repairs.

Roof Repairs to Begin in May...Roof replacement and repair will be the first stage of the Capitol Renovation project. Roof conditions have been completely documented and evaluated, and repair recommendations are ready for working specifications and bid letting. The roof bid package should be ready by the end of March, with repairs scheduled to begin in May with completion in July.

Recommendations Made for Windows...The design team recommended that the windows in the center (original) portion of the building be replaced with modern double hung windows with a secured upper sash. A prototype window with historic profiles was fabricated for the meeting, and the design team and the CAG agreed that while the window is not ideal, its features will improve the appearance and comfort of the building, will be easy to maintain, and are probably the only solution that stays within the established budget.

In the wings of the building, the window solution was a little easier. The design team recommended the repair of the original windows and the replacement of the single pane glass with double pane insulated glazing. There was some concern expressed about the quality of the windows after repair, so the design team obtained an original window that had

been previously removed from the building, and demonstrated that the windows could indeed be repaired and be highly functional. Trim details and color selection were also discussed.

Stone Repair Demonstration Conducted...Dennis Rude of Cathedral Stone demonstrated the proposed stone repair material by restoring a corner at the southeast entry of the Capitol. The repair went very well - stop and look at it when you're in town. The stone repair process was discussed, and, while the repairs will be made with a proprietary material and require trained applicators, the specifications will be broad enough to allow Montana contractors to bid the project. The proposed time schedule for the stone and window repair and replacement involves winter shutdown periods to avoid interruptions during legislative sessions and for quality control in the stone work. CAG members asked the team to investigate the feasibility of year round installation to reduce the costs of project setup and breakdown. The cost effectiveness and product reliability of such an approach will be investigated before a bid package is developed.

LEGISLATIVE AUDIT COMMITTEE

Committee Meets in March...The Legislative Audit Committee met March 29 in Room 108 in the Capitol. The following reports were presented.

PERFORMANCE AUDIT:

- Analysis of Game Warden Work Activities, Department of Fish, Wildlife & Parks, Law Enforcement Division

FINANCIAL-COMPLIANCE AUDITS:

- Montana Single Audit Report
- Department of Health and Environmental Sciences
- Department of Family Services (Followup)
- Department of Corrections, Selected Programs
- Department of State Lands
- Department of Justice
- Department of Administration
- Department of Commerce
- Montana University System Units:
 - Montana State University-Bozeman
 - Montana State University-Northern
 - Montana State University-Billings, College of Technology
 - Montana State University-Billings

LIMITED SCOPE REVIEW:

- Medicaid Expenditures for Durable Medical Equipment, Department of Public Health and Human Services (Medicaid Partnership Plan 95-10A)

Because the meeting occurred so close to **THE INTERIM**'s publishing date, a complete description of the meeting will be available in next month's edition.

LEGISLATIVE FINANCE COMMITTEE

Committee Discusses Budget Process...The Legislative Finance Committee met in Helena on March 14 and 15 to hear a number of reports and discuss several issues.

The Committee held an open forum to discuss the legislative budget process. A number of legislators joined Committee members to discuss possible changes or improvements to the existing process. The two-hour session included comments on the budget development methodology, budget analysis procedures, budget data presented to the legislature, and the legislative process. The following suggestions were made:

- (1) Provide more fiscal and budget briefings and training sessions for legislators, particularly new members.
- (2) Include in the LFA budget book a summary of audit reports, reports by interim committees, and appropriation subcommittee recommendations.
- (3) Provide data showing program budgets as appropriated by the legislature, compared to actual expenditures.
- (4) Involve more legislators in the appropriations process by revising the legislative calendar.
- (5) Place more emphasis on data and debate that deal with issues of fiscal efficiency and effectiveness and less on budget detail.
- (6) Continue de-earmarking effort and review of statutory appropriations.
- (7) Consider establishing interim appropriations committees.

- (8) Develop measurement standards to evaluate programs.
- (9) Provide a summary pamphlet of significant budget data and issues.
- (10) Provide access to budget data through the INTERNET.

A number of other issues were addressed. All issues, along with recommendations for changes, will be summarized in a report to the Committee at the June meeting.

LFD Staff Present a Number of Reports...The Committee heard a report by LFD staff on the potential impact on Montana of federal budget reductions being debated by Congress. In general, the issue is clouded by a lack of agreement on a budget, but because most federal agencies are "forward funded", state federal fund allocations are largely on track with levels appropriated. Exceptions are primarily in the Department of Labor, where some federal funding shortfalls may significantly impact specific programs.

General Fund Revenue Status...The Committee heard a report on the year-to-date revenue collections and the economic factors impacting general fund revenues. The state showed healthy employment growth, but growth in wages and salaries, coal revenues, and interest revenues are below estimates. In general, total general fund collections are slightly below anticipated levels, but are sufficient for budget needs. However, a 1 percent shortfall in anticipated revenues over the biennium would jeopardize the fund balance sufficiency.

Resource Indemnity Trust Fund...Staff presented a report on the Resource Indemnity Trust (RIT) funds. On-going expenses funded from this source exceed on-going revenues. This situation is likely to continue in the future. Therefore, the legislature must re-examine current uses of the fund. The report presented options for examining ways to reduce the complexity of the allocation of revenues to allow for better legislative review and prioritization of program needs. The Committee established a subcommittee of Rep. Grady and Rep. Raney to examine this issue and provide a recommendation to the full Committee at the June meeting.

Corrections Programs...The Committee heard a report on the effectiveness of corrections programs. The report focused primarily on pre-release centers and treatment programs. LFD staff attempted to analyze the effectiveness of pre-release centers in comparison to Montana State Prison, using relative recidivism rates as effectiveness indicators. Due to data limitations, conclusive results could not be reached. Therefore, the focus of the report changed to what the Department needs to do in order to make effectiveness determinations. Staff concluded that the Department does not have an established means of sufficiently evaluating the effectiveness of its programs. The report stated that to evaluate a program it is necessary to establish clear goals and objectives

and to define performance indicators. The Committee will request the Department to develop a plan to monitor and track recipients of treatment and education programs and to advise the Committee of the plan at the June meeting.

Subcommittee on Budget Comparisons Methodology Meets...A subcommittee of the Legislative Finance Committee met on March 14 to develop a method for making comparisons of budget trends from biennium to biennium. Confusion in the last session due to different estimating procedures and measurement goals resulted in a need to develop a common methodology. The Committee agreed to measure total state spending for comparison purposes, and to work on identifying what budget components should be included in the comparison. The Subcommittee will complete it's work and make recommendations to the full Committee at the June meeting. The Subcommittee will meet on May 3 in Room 104 to finalize the recommendation.

Senate Bill 378 Subcommittee Meets...The SB 378 Subcommittee of the LFC, assigned to review statutory appropriations and state special revenue accounts, met March 13 and began its review of the 98 current statutory appropriations. They reviewed 42 statutory appropriations, recommending that 5 be eliminated, and requesting further review of 8 others. The Subcommittee will meet May 2 in Room 104 to continue the review and to formulate final recommendations for the June meeting of the full Committee.

OBPP Reports on Budget Amendments...The Committee was provided a report on budget amendments to date that have been approved by the Office of Budget and Program Planning. Ten budget amendments totaling an additional \$4.0 million and 1.00 FTE were approved in the past quarter, resulting in a total of \$16.4 million and 18.5 FTE approved for this biennium.

LFC to Meet Again in June...The Committee set June 13 and 14 as the date for its next meeting in Room 104 of the State Capitol.

THE BACK PAGE

From most indications, the debate in Washington, DC, and throughout the country about reforming federally imposed taxes will continue. There is even the possibility that the power brokers will substitute a "flat tax" for the existing graduated income tax, or even scrap the whole idea of a national income tax in favor of some version of a national consumption tax, similar to the "value-added tax" (VAT) that exists in Europe or a "goods and services tax" (GST) similar to those that exist in Canada or New Zealand. Drawing heavily upon the research and analysis of Robert B. Strauss of Carnegie-Mellon University, this month's "Back Page" identifies various issues that some readers may wish to introduce as table topics over Easter Brunch, at this week's meeting of the Rotary Club, or at this summer's family reunion. Other readers may choose otherwise.

RIPPLES IN THE TAX REFORM POND **Summarizing the Analysis and Conclusions** **of an Informed Observer**

by Dave Bohyer, Director
Office of Research and Policy Analysis

With the relatively recent curiosity about various "flat tax" proposals, people have begun to consider the possible ripple effects if, indeed, the proposed federal reforms are enacted and implemented. Among those people is Robert B. Strauss, Economics and Public Policy professor at Carnegie Mellon University, who presented some of his research and conclusions to the National Tax Association in October 1995. The remainder of this article extensively summarizes Strauss's remarks of last October, except that his conclusions are taken directly from a recent article in *State Tax Notes*. ("The Effects of a Flat Federal Consumption Tax on the States"; Vol. 10, No. 9; Feb. 26, 1996; pp. 649-659.)

Strauss begins his analysis by sketching the major features of the current federal income tax laws and then compares and contrasts the status quo with various reform alternatives. As he jumps squarely into the debate, Strauss throws down the gauntlet by not-so-politely identifying as "pretenses" five factors used by protagonists supporting wholesale reforms: Pretense 1: Fiscal Nostalgia; Pretense 2: Vertical Equity Concerns; Pretense 3: Correcting Earlier Tax Errors; Pretense 4: Increasing the Rate of Economic Growth by Taxing Consumption; and Pretense 5: Eliminating Tax Expenditures.

Subsequently, he endeavors to debunk the proponents' arguments. First, in rebutting Pretense 1, Strauss asserts that the income tax system of 125 years ago was broader-based, more progressive, and more observant of states' rights than many flat-taxers represent. In refuting Pretense 2, he maintains that progressivity and horizontal equity are both at least pursued under the current structures, something that probably could be lost under various flat taxes. He flatly rejects Pretense 3, saying that the errors of previous tax reform efforts -- mainly, the double taxation of corporate income and the needless classifications of income for individuals -- could be more efficiently remedied with amendments to (rather than repeal of) the existing Internal Revenue Code. While leaving room for debate regarding Pretense 4, Strauss is skeptical of the premise that taxing consumption rather than income will significantly increase economic growth. He takes similar aim at Pretense 5, saying that the "preferences, incentives, or loopholes" cited as nefarious tax expenditures by some flat tax proponents are mostly continued in reform proposals, the one major exception being state and local taxes (which he seems to believe should remain deductible).

In part four of the article, Strauss speaks about goals of tax systems and a state's ability to meet them under federal flat taxes. He lays out the goals of "good tax systems" as: (1) minimum distortion of economic choices; (2) revenue adequacy; (3) simplicity and administrative feasibility; (4) aggregate stabilization (for some older public finance economists); and (5) the achievement of agreed-upon vertical and horizontal equity. Placing priority rankings on the goals, he contends states must place revenue adequacy at the top, if only because of state constitutional budget-balancing requirements. He also doubts the ability of all but a few states to affect economic stabilization through state tax policy, and laments legislatures' (state and federal) inability to broaden (or even sustain) tax bases.

Strauss seems incredulous at some of what is not a focal point of the national debate about flat taxes: the effect on federal and state revenues.

One of the more remarkable features of the emerging debate about the advantages and disadvantages of moving to a federal consumption tax is the complete absence of any discussion about its effects on federal and state revenues. Even seasoned, independent observers... avoid discussing whether or not [the proposed reforms] will bring in promised federal revenues. However, for the states this matter cannot be ignored. (State Tax Notes, p. 656.)

Regarding equity goals and the states vis a vis a flat income tax, Strauss speculates that the elimination of itemized deductions would increase the horizontal equity while current proposals would also simultaneously

decrease the vertical equity. That aside, he also sees significant administrative difficulties for states in addressing new federal levels for the standard deduction and the personal exemption. (If the federal standard deduction and personal exemption amounts remain in the ballpark of those being considered, states would not be withholding for most lower- and some moderate-income wage earners, because these earners would have no projected federal liability.)

Strauss estimates that with a national consumption tax, state-to-state vertical equity would likely decline, assuming that total income (as opposed to total consumption) remains the standard measure of ability to pay. Among other issues he ponders is whether states like Montana and Oregon, each notable for its disdain of consumption taxes, would participate at the state level. Regarding a flat income tax, he poses the similar questions about states like Wisconsin which enacted state income taxes long before the federal government. Almost as an aside, Strauss notes:

... without a federal income tax collection system, states that continue to impose their own personal and business income taxes would likely find a decline in taxpayer compliance because the threat of any IRS income tax audit would be eliminated.

In short order, Strauss also points to several additional matters that should be (and would be!) concerns of the states.

Regarding tax administration: If, as some reform models contemplate, federal tax withholding disappears and is replaced with, essentially, voluntary payment, states would not be able to maintain their own, independent withholding system for the collection of the wage tax, with the result that collections at both the federal and state levels could be at risk.

Regarding state and federal borrowing: With no national income tax, it seems likely to Strauss that borrowing costs [of private vs. public debt] would converge. With debt now tax-free, the market for state and local debt would narrow. The remaining advantage of private holding of public debt would to be reduced risk, and the risk premium for federal debt would likely be lower than for state or local debt. Disadvantage: states and local governments.

Regarding political costs of state and local taxes: Strauss ventures that the cost of eliminating the deductibility of state and local taxes is that it raises the state-level political price of financing state and local services, and the individual political stakes. If true, that may cause states to hide their taxes or target them on less politically influential activities.

Regarding state vs. local governments: Declines in federal aid to states have historically presaged declines in state aid to local governments and increases in state mandates to locals. Strauss can envision this pattern causing greater pressure on local governments budgets, which would mean either greater reliance on locally imposed (property) taxes or declines in services.

Regarding reliance on individual vs. business taxpayers: Strauss notes that under several reform proposals and for various reasons, a relatively greater portion of revenues would be raised from business than currently. The indirect result of movement to a consumption tax for the states could be the increased importance of business apportionment issues and dealing with more aggressive business tax planning.

Based upon his research and analysis, Strauss draws some rather intriguing -- if not distressing -- conclusions. The following, highlighted in italics, are his conclusions.

Unlike my thought on how the Tax Reform Act of 1986 would affect state corporate income tax revenues some year ago, my view here is that the stakes for the states this time are quite real. What is remarkable in the flat tax debates to date is that the effects on state tax systems have been barely mentioned, with [few] exceptions....

*A chief characteristic of most of these proposals is that they move our federal tax system from the taxation of household and business income and wealth (at time of death) to the taxation of current consumption. As such, they raise the possibility of ending the tacit agreement between the federal government and the states to abstain from deriving revenues from the states' gross receipts, sales and use and excise tax bases, and the **de facto** sharing of the household and business income tax bases through state harmonization, albeit incomplete, with the federal personal and business income taxes.*

*The national economic pretext for moving to a consumption tax rests primarily on the hoped-for response in the **rate** of national savings and a permanent increase in the rate of sustainable economic growth. While the econometric evidence on the savings rate issue is mixed, one can also make the argument that if we did move to consumption taxation, and did not change our [economic] course for a considerable period of time, the savings rate would respond. How much so is more than a passing matter, for if we do not grow much faster than we are scheduled to, our ability to raise sufficient revenues to finance federal, state, and local services could easily be at risk.*

Administrative simplicity and compliance costs for various types of consumption taxes could easily be the same as or higher than under current federal and state laws.

Unless the economic pie grows radically faster under a new system of federal and state consumption tax, it is likely that many, even a

voting majority, would find themselves with less after-tax income than before. Also, there could be very significant deteriorations in vertical progressivity [of taxes]. Because hoped-for economic growth effects are expected to take several years at a minimum, it is difficult to imagine that those made initially worse off under the new tax regime, which could easily be a voting majority, would not notice and react.

I find the argument that movement to a consumption tax would correct major errors in the Tax Reform Act of 1986 to be unpersuasive. The elimination of the double taxation of corporate-source income and the elimination of the undue classification of federal income taxes are both readily achievable within the context of existing income tax law with no significant effects on the states. If much of the pressure for a national consumption tax is coming because of these two earlier mistakes in tax policy, then the obvious thing to do is correct them, rather than creating a new structure that could have very serious transition problems at the federal level.

The states, facing massive uncertainty about how many policy and technical details of such a change in federal tax policy would be worked out, would necessarily have to stand by and use their current hybrid consumption-income tax systems to finance the costs of needed public services. Once the dust settles in Washington, which could be several years after enactment, they would have to decide whether to follow or not.

My best guess is that if the states wish to continue their hybrid consumption-income tax systems while the federal government goes off to some form of a consumption tax, the states might well have to uncouple from the Internal Revenue Code.

However, decoupling does raise the specter that the states could undo the administrative efficiency gains hypothesized, by optimists, to be won by moving to a flat consumption tax. Further, if the economic pessimists are correct, a federal move to a flat tax could increase budgetary uncertainties at the federal and state levels. Moreover, to the extent each state goes its own way in terms of tax policy as a consequence of the federal move to a flat consumption tax, the risk that the states might move towards cascading gross receipts taxes, thereby increasing the amount of dead-weight loss in the economy compared to current laws, seems entirely possible.

The constitutional heart of the risk I perceive in federal consumption taxation for the states is the deal struck by the Founding Fathers when state taxing powers were agreed to at the Constitutional Convention. Unfortunately, fiscal concurrency, the independent authority of each state to devise its own fiscal system until told by the Supreme Court it has gone too far, and the interplay between state and federal tax policy remain forgotten topics for tax specialists who work in Washington. The growing hubris in state capitals, encouraged by the dazzle of super federal block grants, could easily lead to greater diversity and nonuniformity in state tax policy.



INTERIM CALENDAR

UNLESS OTHERWISE SPECIFIED,
ALL ROOM DESIGNATIONS ARE IN THE CAPITOL

APRIL

April 4, Legislative Council Legislative Improvement and Mission Subcommittee, 269 West Front Street, Missoula, 1 p.m.

April 10, EQC Environmental Self-Audit Group, Helena

April 12, Tax Policy Task Force, Room 415, 9 a.m.

April 12, Tax Policy Task Force Public Hearing, Room 415, 7 p.m.
(See pages 8 & 9 for METNET sites.)

April 13, Tax Policy Task Force, Room 415, 8 a.m.

April 15, Committee on Postsecondary Education Policy and Budget, Room 104, 9 a.m.

April 15, Juvenile Justice and Mental Health Study Commission, MSU College of Technology, Great Falls, 9 a.m.

April 15, Juvenile Justice and Mental Health Study Commission Public Hearing, McLaughlin Center, University of Great Falls, Great Falls, 7 p.m.

April 16, Juvenile Justice and Mental Health Study Commission, MSU College of Technology, Great Falls, 8 a.m.

April 18 and 19, Subcommittee on State Management Systems, Room 437, 9 a.m.

April 25, EQC Enforcement/Compliance Subcommittee, Room 104, 8 a.m.

April 25, EQC MEPA Subcommittee, Helena, Room 108, 1 p.m.

April 26, Environmental Quality Council, Room 104, 8 a.m.

MAY

May 2, LFC Subcommittee on SB 378 (de-earmarking), Room 104, 8 a.m.

May 3, LFC Subcommittee on Budget Comparisons, Room 104

May 3, 4, and 5, Montana Legislative Conference on Higher Education, Yellow Bay, Flathead Lake

May 9 and 10, Oversight Committee on Children and Families, Room 104, 9 a.m.

May 16, Subcommittee on Veterans' Needs, Eastern Montana Veterans' Home, Glendive

May 23 and 24, EQC Enforcement/Compliance Subcommittee

May 27, Memorial Day, holiday

JUNE

June 6 and 7, Committee on Indian Affairs, Fort Peck Reservation, Poplar

June 7, Committee on Public Employee Retirement Systems, Room 104, 8 a.m.

June 10 and 11, Subcommittee on State Management Systems, Room 437

June 13 and 14, Legislative Finance Committee, Room 104

June 14, Legislative Council (tentative)

June 20, Oversight Committee on Children and Families, Room 104, 9 a.m.

June 20 and 21, Gaming Advisory Council, Room 325, 9 a.m.

June 26, EQC Enforcement/Compliance Subcommittee

June 27, EQC MEPA Subcommittee

June 28, Environmental Quality Council

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